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Q2 2020 Synalloy Corp Earnings Call

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CORPORATE PARTICIPANTS

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Sally M. Cunningham *Synalloy Corporation - Senior VP, CFO & Corporate Secretary*

CONFERENCE CALL PARTICIPANTS

Charles Gold

PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Synalloy Second Quarter 2020 Earnings Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions)

I would now like to hand the conference over to your speaker today, Craig Bram, President and CEO. Thank you. Please go ahead, sir.

Craig C. Bram ***Synalloy Corporation - President, CEO & Director***

Good morning, everyone. Welcome to Synalloy Corporation's Second Quarter 2020 Conference Call. Joining me today is Sally Cunningham.

Sally is Synalloy's new CFO, taking on that role as of July 1. Prior to joining Synalloy almost 5 years ago, Sally worked extensively in finance and accounting for several public companies. Coupled with her knowledge of our businesses and management teams, she's a natural fit to step into this position. I know that she will do a great job.

Before turning the call over to Sally, I'd like to make a few general remarks.

Second quarter was, without a doubt, the most challenging that I've experienced during my time with Synalloy. Even prior to the arrival of the COVID-19 pandemic, we anticipated a difficult year for manufacturing.

While the ISM Manufacturing Index rose to 56% in August, confidence in the recovery appears weak as manufacturers continue to reduce employment levels. Chemical products and fabricated metals products both showed growth during August for the first time since the outbreak of the pandemic. Demand for welded stainless steel pipe in North America is tracking very closely to the recessionary levels witnessed in 2016.

The Saudi-Russian oil price war, along with the virus' catastrophic hit to oil demand, has created an environment where producers are unable to earn their cost of capital.

Activity in the Permian Basin has come to an abrupt halt, and there's no sign of a quick return to pre-COVID-19 production levels.

Against this backdrop, we've had to make some difficult decisions. We've reduced our headcount by more than 10% since the beginning of the year. The executive team and other highly paid employees have reduced their salaries by between 8% and 25%. And we have eliminated the company's 401(k) match for the second half of 2020.

At the end of June, the company made the decision to exit the Palmer of Texas business. The assets are currently being marketed for sale, and the proceeds will be used to reduce our line of credit.

During the second quarter, the executive team and Board of Directors spent considerable time and money on the proxy contest. Total cost of this effort was approximately $3 million. We are most pleased to have this behind us and look forward to working with the newly constituted Board of Directors, led by our new Chairman, Henry Guy.

Despite everything that has occurred in 2020, the company made excellent progress on multiple fronts. After Sally reviews the financial results, I'll spend some time commenting on the performance of our business segments. We will then open the call to questions.

I'll now turn the call over to Sally.

Sally M. Cunningham ***Synalloy Corporation - Senior VP, CFO & Corporate Secretary***

Thank you, Craig. Good morning. As is usual practice, I will present the financial results using 3 different methods: one, GAAP-based EPS; two, adjusted net income, a non-GAAP measure as defined in the earnings release; and three, adjusted EBITDA, a non-GAAP measure also defined in the earnings release.

Starting with GAAP-based EPS. For the second quarter, the company reported a net loss of $7 million or $0.77 diluted loss per share as compared with a net loss of $0.3 million or $0.03 diluted loss per share for the second quarter of 2019. The primary factors contributing to the current quarter losses were: $1.9 million in pretax operating losses at Palmer of Texas; a $6.1 million noncash impairment charge at Palmer; $2.7 million in costs associated with the company's proxy contest; and the increase in inventory price change losses of $1.7 million in Q2 of this year over Q2 of last year.

For the 6-month period, the company reported a net loss of $8.1 million or $0.90 diluted loss per share as compared with a net loss of $1.2 million or $0.13 diluted loss per share for the first 6 months of 2019.

The primary factors contributing to the current year losses were: $2.7 million in pretax operating losses at Palmer; $6.1 million noncash impairment charge at Palmer; $2.9 million in costs associated with the company's proxy contest; and the decrease in inventory price change losses of $1.3 million.

Moving on to second quarter. Non-GAAP adjusted net loss was $1.1 million or $0.11 diluted loss per share compared with an adjusted net loss of $0.3 million or $0.04 diluted loss per share for the second quarter of 2019.

For the 6-month period, the adjusted net loss was $1.8 million or $0.19 diluted loss per share compared with an adjusted net loss of $0.3 million or $0.04 diluted loss per share for the first 6 months of 2019.

And finally, second quarter non-GAAP adjusted EBITDA was $1.9 million, down from $3.4 million in the second quarter of 2019.

For the first 6 months of 2020, adjusted EBITDA was $4.6 million, down from $8.2 million in the first 6 months of 2019.

Both the adjusted net income and the adjusted EBITDA total, including add-back for $2.7 million and $2.9 million for the proxy contest-related cost in the second quarter and six month periods, respectively.

As pointed out in the earnings release, the inventory price change losses in the second quarter this year reduced pretax income by $3.5 million. By comparison, in the second quarter of last year, inventory price change losses were $1.8 million.

Nickel surcharges compared with surcharges posted 5 months earlier, turned positive in August and September and are presently forecasted to be positive in October as well. If this trend persists, we should start seeing inventory price change gains in the fourth quarter.

Net debt at the end of the second quarter totaled approximately $77 million.

I will now turn the call back over to Craig.

Craig C. Bram ***Synalloy Corporation - President, CEO & Director***

Thank you, Sally. Entering 2020, we expected the manufacturing economy to reflect the bottoming in the business cycle.

The cost-cutting initiatives pursued in the latter part of 2019 were in response to the weakening in demand that we were seeing across most of our end markets.

As we've done in previous low points of the business cycle, the company's priorities are straightforward: Number one, keep our mills, reactors and other production equipment operating at close to full capacity. Number two, take market share whenever possible. Number three, lower or maintain our cost per pound shipped. Number four, focus on quick payback capital projects. And finally, number five, reduce net debt.

Our cost-cutting initiatives have generated positive results across the company. In the Chemicals segment, adjusted EBITDA improved to $2.45 million in the second quarter of this year, an increase of 86% over the same period last year, this on marginally less revenue.

Our pipe and tube businesses, Bristol metals, ASTI and specialty pipe and tube, generated adjusted EBITDA of $2 million in the second quarter, down 30% from the same period last year. The increase in inventory price change losses from $1.79 million in Q2 of last year to $3.51 million in Q2 of this year was the key factor in the year-over-year decline.

The operating teams have done an exceptional job in reducing the cost per pound shipped across all business units. Looking first at the Chemicals segment, the cost per pound shipped for manufacturing labor and benefits in the first half of 2020 declined by 10% as compared with the full year 2019.

Other manufacturing expenses per pound shipped declined by 15% in the first half of this year, while SG&A expenses per pound shipped declined 16% in the first half of this year.

With the heavy wall seamless carbon pipe and tube product line, manufacturing labor and benefits per pound shipped declined by 13% in the first half of this year compared with the full year 2019.

Other manufacturing expenses per pound shipped were flat with the same period last year as were SG&A expenses.

Manufacturing labor and benefits per pound shipped for the ornamental tubing business increased by 2% in the first half of this year compared with full year 2019.

Other manufacturing expenses per pound shipped were flat and SG&A was down 2% when compared with the full year 2019.

Finally, Bristol Metals saw their manufacturing labor and benefits per pound shipped in the first half of 2020 fall by 6% compared with the full year 2019. Other manufacturing expenses per pound shipped were down 3%, while SG&A was off 17% when compared with full year 2019.

Bristol Metals share of the North American market for welded stainless steel pipe increased by 320 basis points in the first half of 2020 as compared with the same period last year.

With transportation-related markets weakening for polished ornamental tubing, ASTI moved production to support sales to the medical sector.

Late in the third quarter, the Chemicals segment responded -- excuse me, late in the first quarter, the Chemicals segment responded to the pandemic by developing a formula for hand sanitizers. Following approval by the FDA, this new product line generated $1.5 million in revenue in the second quarter of this year. Our businesses continue to demonstrate their ability to quickly respond to market conditions.

There are several high ROI capital projects currently underway.

At Bristol Metals, Munhall facility, the new rework shop will be operational by the fourth quarter. The annual savings from this initiative are targeted $750,000 with a payback period of less than 18 months. Like the rework shop in Bristol, Tennessee, the Munhall facility will repair defective pipe instead of scrapping it.

Another capital project at Munhall is the acid regeneration system for the pickling process. The annual savings from this project are estimated at $150,000 a year with a payback period of less than 18 months.

Achieving our debt reduction targets for the balance of the year will be a primary focus. We continue to whittle down our interest expense. In the second quarter, interest expense was down $462,000 from the same period last year. And for the first half of 2020, it was down $749,000 from the same period last year.

Finally, as stated in the earnings release, because of the uncertainty related to COVID-19 pandemic, we have suspended all fiscal 2020 guidance and are not providing guidance at this time.

With a full restart of the economy pending, we cannot predict the impact on our various businesses. We remain diligent and thoughtful in managing profitability and liquidity, while navigating these unprecedented times and continue to execute on our strategy.

We'll now open the call to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of David Secrid. Pardon me. Our first question comes from the line of Charles Gold from Truist Financial.

Charles Gold

The proxy fight was hard on everybody, and it seemed like the Privet people and the management and old Board members disagreed on virtually everything, especially the way the company was being run. But there was one thing that had total agreement, and that was that Synalloy's business is worth considerably more than the stock reflected. I think Privet in there materials thought they could get the stock back to 25, and the company said they'd already proven that they could do that feat back in 2018 and had EBITDA in the $35 million to $40 million run rate. So now that we've got COVID and a COVID period and are preparing to jettison Palmer, does the Board and the current management believe that valuation possibility is still there? And that the company's earning power, ability to produce EBITDA and bottom line, earnings, is not impaired too much to still produce those numbers down the road?

Craig C. Bram ***Synalloy Corporation - President, CEO & Director***

Charles, this is Craig. Let me address that. Obviously, right now, we believe we're at the bottom of the business cycle. Certainly is the case with our largest business unit, their volume is trending at recessionary levels that we saw in 2016. And there's no question that in 2018, the company demonstrated the ability to earn $34 million of adjusted EBITDA was the number in 2018. And of course, we did not own ASTI until January 1 of 2019. That business contributed approximately $6 million of EBITDA for us in 2019. So that gets you to the $40-plus million of earnings potential on an adjusted EBITDA basis.

The Palmer operation has basically been a drag for the last several years. It's been either marginally positive on an EBITDA basis or marginally negative, but it's also been a management time hog. So jettisoning that business, we believe, is obviously the right thing to do.

We don't see that business or that market returning to the point where we can earn a reasonable return on our capital. We think that capital can be deployed more effectively in other businesses. But absolutely no doubt that the earnings power of the business remains. Some of the projects that we're working on right now that I mentioned, particularly at Munhall, improves the earnings capability of that business beyond what they did in 2018. So we feel very positive about the earnings potential of business once the end markets that we primarily serve return to stronger demand levels.

Charles Gold

All right. Different subject. The 10-Q and -- it was late. You got slapped on the wrist by NASDAQ and the earnings came out considerably later than planned. There were several issues mentioned in that disclosure, including a lawsuit and hiring outside counsel and issues of accounting that came up. And I guess, we'll see the 10-Q shortly, if it's not already out. Could you tell us how the 3 issues, I think, have been resolved or are being resolved? And what the slate looks like going forward?

Craig C. Bram ***Synalloy Corporation - President, CEO & Director***

Sure. So the 10-Q is going to come out later today, probably after the market closes. So I alert you to that. The Item 4 in the 10-Q addresses, Charles, the items that you raised.

Number one, there has not been a lawsuit. So let me be clear on that. The investigation that's been referenced before, that has been concluded by an independent law firm. And there was no evidence of intentional misconduct, bad faith or criminal acts. So that investigation is over and completed.

We are going to report a material weakness in that 10-Q, again, in Item 4 we'll provide the details. I can tell you that there are 4 deficiencies that are referenced in that part of the 10-Q. And I can also tell you that individually, none of them alone would constitute a material weakness. But in aggregation, they do. So that -- those details will be provided in Item 4 of the 10-Q.

As far as the remediation efforts on that, that's also specifically addressed in Item 4 of the 10-Q. And I think that speaks for itself.

Did I cover all the questions, Charles, you had there?

Charles Gold

I think you did. There was a reference to, I guess, a Palmer employee that had, had accusations. And that was -- is the investigation centered on that?

Craig C. Bram ***Synalloy Corporation - President, CEO & Director***

That was the investigation, Charles -- I guess, it's categorized as a whistleblower complaint, but it was not a Palmer employee and -- but it did have to do with Palmer accounting issues. But yes, the investigation looked at that and it's been concluded with, with no finding of any wrongdoing or bad faith or criminal acts.

Charles Gold

And for you and/or Sally, with this impairment write-down on Palmer, if the company is sold, what -- and proceeds are received, has Palmer been written down to 0? And might there be some recapture, if Palmer has some value to another party? Or have we been conservative in the write-down as we've taken it as far as we can legally take?

Sally M. Cunningham ***Synalloy Corporation - Senior VP, CFO & Corporate Secretary***

Yes, absolutely. This is Sally. We did write down Palmer to the appropriate value associated with us stopping operations and actively marketing it out in the business.

Charles Gold

And back to number 4 that we're going to see. We will see what actions are being taken, and that they're taken appropriately, you will be in good standing with your accountants?

Craig C. Bram ***Synalloy Corporation - President, CEO & Director***

Absolutely. Yes, Charles, there's never been any question on the -- on the numbers being reported. It gets back to primarily internal control issues.

Operator

Our next question comes from the line of [David] with [Seek First], Private Investor.

Unidentified Participant

Craig and Sally -- so Sally, just a congratulations on your promotion to CFO. That's nice. So then I take it that we are now compliant with bank covenants and SEC listing requirements, is that correct?

Sally M. Cunningham ***Synalloy Corporation - Senior VP, CFO & Corporate Secretary***

That is correct.

Unidentified Participant

Okay. Good. And then I noticed in the press release this morning our tangible net worth, I think we said was at least $67.4 million. So is my math correct? That's about, what, $7.40 a share?

Craig C. Bram ***Synalloy Corporation - President, CEO & Director***

Yes, there's 9,058,000 shares outstanding. So I don't have a calculator in front of me, David, but maybe somebody else does.

Unidentified Participant

Okay. I think that's about what I came up with.

Craig C. Bram ***Synalloy Corporation - President, CEO & Director***

Yes, $67 million. That gives you a tangible net worth of $7.40.

Unidentified Participant

Okay. Very good. Question on our $1.1 million gain on investment securities. Could you talk a little bit about what that is?

Craig C. Bram ***Synalloy Corporation - President, CEO & Director***

Yes. From -- David, from time to time, we will take a position in a public company that we think might be a possible acquisition target. We've done that 3 or 4 times over the last 10 years. And we always own less than 5%. So we can avoid a filing on it. And in this case, a company that we had owned, made a very substantial move in the second quarter, creating that mark-to-market gain of $1.1 million. We have since sold that position in its entirety. And I think the net proceeds were between $4.4 million and $4.5 million, somewhere in that range.

Unidentified Participant

Okay. Now I see our debt at $78.6 mil; cash, $1.4 billion. So we feel comfortable -- I know you mentioned in your remarks that we'll be managing prudently our debt to cash position.

Do you feel like, being where we are in the business cycle that we can manage our debt and reinvest in the business as needed, so that we could hit the sweet spot going up out of this slope, this trough?

Craig C. Bram ***Synalloy Corporation - President, CEO & Director***

Let me comment on that and Sally can jump in as well. This year, we did reduce our capital expenditures budget by about $2 million. We didn't exclude any high-ROI projects. We focused exclusively on those. That's why the Munhall projects continue to roll out, and we'll see the benefit of those starting in the fourth quarter.

On the cash flow front, we've got some cash that we expect to come in over the balance of the year. We've got $3 million in tax refunds that will be coming in. We will -- as we do typically, we see our inventory levels come down in the second half of the year, particularly in the fourth quarter. So that will reduce our working capital needs.

David, as I mentioned to you, I think, on a call a couple of weeks ago, we do feel like we're a little thin right now in terms of our capacity on the ABL. And typically, we like to be $10 million to $12 million. I think we ended the second quarter at $7 million, $6 million to $7 million. And that was primarily a function. We had -- our inventory valuation that was done twice a year, where the ABL, it was done in March -- March 31. And it was a pretty conservative valuation on our metals inventory because of all the pressure the metals industry was seeing at that point in time. That -- the second valuation will take place likely in October. And of course, we've seen an uptick in nickel prices, nickel surcharges. So we expect, we're going to get some of that capacity back when they do the inventory valuation here in the fall.

So ideally, we like to have $10 million to $12 million of available capacity to manage the ongoing operation, to manage the CapEx projects that we think are most critical to the business.

Unidentified Participant

That makes sense. Good job with the chemicals this past quarter. I saw $2.1 million operating income in second quarter in chemicals. That's really good. Now I noticed an article the other day, you introduced manu FDA surfactant. So -- and probably, I think you mentioned some other introductions in chemicals in the second half. So how long does that take, once we release a product to kind of start affecting the bottom line?

Craig C. Bram ***Synalloy Corporation - President, CEO & Director***

Yes. The process is actually pretty long, David. It -- we track our products as in a pipeline from Phase 1 to Phase 4. Phase 4 being, the product is fully ramping in production and we've got some visibility on what kind of pounds and the impact is going to be. But so we move -- the Phase 1 is basically an idea. Phase 2 is some testing that we're doing, preliminary testing that we're doing for a potential customer. Phase 3, we've gone into some small-scale production. But all through that process, we're not only trying to meet the requirements of our customer, but those samples then in turn are shared with our customers' customer. So it can take as much as a year to go from Phase 1 to Phase 4. And what we tried to do is identify the products that are in Phase 4. They've got some visibility, and we feel like we know what the pounds and the impact on the facility is going to be.

We've got our Cleveland, Tennessee plant operating at about 85% capacity right now, so we're somewhat limited in what we can bring into that plant in terms of new products.

We're only operating at about 50% capacity at CRI, so we got a lot more capacity to bring in, reactor and blend products. And some of our most interesting products in the pipeline would go specifically into CRI. And because it doesn't require us to add additional labor, a lot of that contribution margin will go straight to the bottom line.

So it takes a while for these things to come to pass, and it's hard to -- but so far out to give any impact visibility to our shareholders. But certainly, we like what's in the pipeline in the Chemical division right now. We like the cost-cutting initiatives that those guys executed on, that we put in place at the -- in the fourth quarter of last year. And that's why we had such a sizable -- sizable comp in EBITDA, even though our sales went down by 1%.

Unidentified Participant

Right. That's true. Yes, very good. You mentioned in the PR a while back that you were shipping 2 semi-trailers a week of hand sanitizer. Is that still something that's happening due to COVID demand?

Craig C. Bram ***Synalloy Corporation - President, CEO & Director***

There's been a little bit of a drop off. Obviously, there was some spiking going on early in the second quarter as people were trying to get their supply. But we've got some bids out now to some new customers that didn't participate during that spike period. So we feel pretty good that, that's going to continue to be a nice contributor to the chemical business.

Unidentified Participant

Good. Another question regarding -- I noticed in the press release today, stainless steel pricing is up 27% in the second quarter. Any color on that?

Craig C. Bram ***Synalloy Corporation - President, CEO & Director***

I don't have that in front of me, David. But I mean, I can tell you that the -- starting in August, nickel prices started moving up and surcharges going hand-in-hand with that. And it's continued into October. It's a little bit baffling from the standpoint that on a pure supply and demand basis, nickel is in -- in surplus right now. But the -- the shortfall, I guess, in China and their ore inventories and then the Philippines came out with a reduction of their raw material production, I think that's what's driven nickel above $7 a pound.

I think what you referenced in the earnings release had to do specifically with special alloys. So we have seen pricing improved in the special alloy area, primarily due to those special alloys. They're tied to projects. The project activity is still depressed. But there'll be periods of time where we'll get a couple of projects. I think this one was related specifically to a mining project, and that will push temporarily up our selling prices on an average basis.

Unidentified Participant

Okay. That makes sense. One last question, and that's regarding analyst coverage. And I know Synalloy is very cyclical. But do we have any plans for like investor conferences, analyst coverage that can help get the message out to mainstream America regarding this company?

Craig C. Bram ***Synalloy Corporation - President, CEO & Director***

Yes, David, we've typically tried to do at least one conference a year. We haven't done one this year because of the COVID situation. I think most of those have been virtual kinds of setups and a lot of just haven't been held. But we try to do 1 or 2 of those a year.

Yes, there was a time when we had 2 analysts following us. It was after the follow-on offering that we did back in 2013. Unfortunately, one of those groups did away with their research department entirely and the other group got absorbed into a larger investment banking group.

But at this point, we don't have an analyst covering, as we've been approached by groups that our company pay. Meaning we would pay them $30,000, $40,000, $50,000 a year to provide research on us. We've been told that it's kind of questionable when you get a research house like that covering you. Paying for your own research, I guess, impacts whether you're getting objective reviews. But we would certainly be interested in getting coverage, but the best kind of coverage would be from a small house that was doing it, just as part of your natural business.

We don't have any plans to raise capital at this point. And that typically also kind of goes hand-in-hand with getting some analyst coverage from the folks that help you raise the cap.

Unidentified Participant

Yes. That makes sense. Well, in time, as the results improve, that will speak for itself as well. So -- but thank you for those comments. Appreciate it.

Operator

(Operator Instructions) Our next question comes from the line of Charles Gold from Truist Financial.

Charles Gold

This is more of a hope and a desire than a question. But because the proxy fight was so hostile, I would hope, and I think all shareholders would desire, that the old Board members and the new Privet Board members work totally together to grow the value of this company. I hope they're not working at crossed purposes and anything. Either contingency -- either contingent can do to make that transpire will be in the best interest of all the shareholders.

Craig C. Bram ***Synalloy Corporation - President, CEO & Director***

Thank you, Charles.

Operator

Thank you. At this time, I'm showing no further questions. I would like to turn the call back over to Craig Bram for closing remarks.

Craig C. Bram ***Synalloy Corporation - President, CEO & Director***

I'd like to thank everybody for their participation today and the questions. We appreciate it very much. Thank you.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.